Moody's Investors Service

Global Credit Research
Credit Opinion
16 OCT 2006

Credit Opinion: TMK

TMK

Russia

Ratings

Category	**Moody's Rating**
Outlook	Positive
Corporate Family Rating	B1
TMK Capital S.A.	
Outlook	Positive
Bkd Senior Unsecured	(P)B2

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Key Indicators

[1][2]
TMK

	2005	**2004**	**2003**
EBIT Margin	**15.8%**	**7.3%**	**1.2%**
EBIT / Interest Expense	**5.7**	**1.4**	**0.5**
Debt / Book Capitalization	**31.7%**	**41.0%**	**22.7%**
Debt / EBITDA	**1.2**	**3.3**	**4.0**
(CFO - Dividends) / Debt	**55.0%**	**3.1%**	**-26.8%**
FCF / Debt	**36.4%**	**-5.0%**	**-43.3%**

[1] Based on Moody's standard analytical adjustments [2] For definitions of Moody's ratio terms please see Moody's Global Steel Industry rating methodology

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Company Profile

Headquartered in Moscow, Tube Metallurgic Company ("TMK") is Russia's largest and one of the world's leading manufacturers of value-added steel pipe products for the oil & gas industry. In addition, the company produces pipes used in construction and machine building. 67% of OAO TMK is indirectly owned by Dr. Dmitry Pumpyanskiy. The company has a 42% market share of Russian pipe production and operates 6 plants located in South-West Russia, Urals and Romania to serve domestic and international oil & gas and industrial clients. TMK has shipped more than 2.9 million tonnes of pipe products in 2005 and generated revenues of USD2.9 billion.

Recent Events

On September 7, 2006, Moody's Investors Service assigned a B1 corporate family rating to TMK and a (P)B2 senior unsecured rating to the loan participation notes issued by TMK Capital S.A., guaranteed by the operating subsidiaries of TMK. The outlook on both ratings is positive.

The proceeds of the USD 300 million note will be on-lent to TMK's majority shareholder and used to finance the planned increase of his 67% stake in TMK. Proceeds that the majority shareholder will receive from the planned IPO will be used to repay his loan received from TMK. The company will subsequently use these proceeds to finance its capital expenditure program.

Rating Rationale

The current B1 corporate family rating is driven by the company's scale and diversification, earnings and cashflows, and credit metrics which currently are in in-line with the peer group. The B1 rating reflects the high degree of volatility in the company's business, given that 65% of TMK's sales are directly to end-users in the oil and gas industry.

In assigning the ratings to TMK, Moody's has taken into account TMK's position as the largest manufacturer of value-added pipe products in Russia, notably for the oil and gas industry. Moody's also views the company's geographic focus on the rapidly developing Russian and CIS markets, as well as the strategy to diversify into European, Middle Eastern and Asian markets as a credit positive for future cash flow potential.

The rating also reflects TMK's relatively sizeable debt position, including indebtedness at the level of the shareholder, following the planned increase of the majority shareholder's stake under as yet undisclosed terms and conditions. The initial financing of this transaction will proceed directly and indirectly via debt at TMK level as well as at shareholder level. It is Moody's assumption that the debt at shareholder level will also have to be served via increased dividend payments of TMK.

The rating further factors the company's uneven past performance and short credit history - TMK has existed in its current form only since 2002-2003 - as well as the weak liquidity structure following the planned shareholder transaction with a sizeable portion of initial indebtedness being short term. The debt structure and reduction in cash balances places a high dependency on a successful bond issue and IPO, which is expected later in 2006.

In terms of scale and diversification, TMK's revenues and asset size are within the Ba range. For FYE 2005, TMK reported revenue of $ 2.94 billion, which compares favourably to the Ba rated peer group (both steel manufacturers and heavy goods suppliers to the oil and gas industry), this measure has doubled since 2003 as the company has not only benefited from the continued good industry environment for oil and gas drilling and transmission pipes, but also from its acquisition activity which placed them advantageously close to major Russian oil and gas drilling areas and scrap abundant territories, as well as a good access to sea ports. Going forward, TMK would need to increase capacity to achieve organic growth.

TMK's product mix is adequately diversified as it provides pipes for drilling activity, oil and gas gathering and transportation, and for various machine building and construction applications. The implementation of a modernisation programme, which includes efficiency gains and quality improvements, will enable TMK to further diversify its product profile. With strong market position in seamless and large diameter welded pipes; the company can serve its quality customer base including all Russian oil and gas majors. It is expected that going forward, the demand for oil and gas tubes will be sustained by the higher level of exploration and production expenditure by oil companies and by the increasingly difficult conditions under which wells are operated (deep, offshore, deviated wells). Although, the outlook for commodity prices remains very supportive, the inherently volatile oil and gas industry, and more specifically, the drilling cycle which moves in conjunction with commodity prices will effect the company in the mid term.

The production of large-diameter pipes is currently backed by multi-year contracts. The demand will drive higher revenues for this product as there are 87,000 km of pipes under construction or projected over the next 5 years including 18 major pipe projects in the CIS including 10 projects - in Russia, 5 - in Kazakhstan and 3 - in Turkmenistan and Uzbekistan. However, Moody's noted that there is a concentration of revenue, with one customer accounting for nearly 25% of consolidated revenues.

The company's earnings, cash flows and returns are currently superior to Ba rated names but are more volatile and can worsen in softer market conditions. Over the last 2 years EBIT margin significantly improved from 1.2% in 2003 to 15.8% in 2005 as a result of implementation of investment program which included quality improvements, vertical integration and modernisation of pipe production facilities. It is expected that it would enable the company to further improve margins up to 17%-18% in 2006/2007. However, as the demand is expected to slowdown after 2008, the margins could fall below current good levels by 2009. In addition, there is a cost pressures associated with steel and scrap prices and its reliance on third-party supplies, especially suppliers of scrap, which can significantly impact margins despite robust market conditions and ability to pass along higher steel and scrap costs. Further, the pressure on margins will increase with intense competition from other Russian producers and imports, notably from Ukraine, in certain product segments.

TMK is positioned in B1 rating category in terms of cash flow leverage measures. The company's leverage as measured by Debt/EBITDA has improved over the last 3 years from 4.2x in 2003 to 1.2x in 2005. However, when the historical leverage is adjusted for the full financing for a proposed shares buy-back, the ratio will fall to 2.6x. If expected IPO will be successful, the company can restore its leverage metrics to a comfortable level of app. 1.0x.

In terms of book leverage, TMK demonstrates modest balance sheet leverage for a B1 rating category, even prior to any potential IPO at 59%. Given the higher degree of volatility in TMK's core business and the primary use of debt to finance the modernisation programme and the share buy-back, the company needs to have a below average leverage profile to support the rating.

In terms of coverage measures, the company's historical ratios have been within the Ba3 peer group with EBITDA/Interest 2.5x (based on average 3 yr. results) and FCF/adj. Debt of - 3%, which is more close to Caa category. When adjusted to the full financing for shares buy-back and expected IPO, the coverage is expected to restore and remain at a comfortable level to B1 rating category going forward.

The rating of the loan participation notes has been notched down to (P)B2 in light of the subordination to existing secured term bank debt. Carve-outs in the indenture also allow for substantial additional indebtedness to potentially rank ahead of the Notes (up to more than 10% of total assets, translating into more than USD400 million of secured indebtedness). Moody's expects that the current subordination of 22% secured to unsecured debt will remain above 20% going forward.

The loan participation notes are subject to various restrictions and financial covenants, including a maximum debt/EBITDA ratio of 3.5x and limitations regarding additional indebtedness. Moreover, dividend payments are restricted subject to a basket of 50% of net income and the possibility to incur USD1 additional debt under the debt/EBITDA ratio.

The assigned ratings assume that there will be no material variations to the draft legal documentation reviewed by Moody's and that these agreements are legally valid, binding and enforceable.

Rating Outlook

Moody's positive outlook on the rating reflects the expectation that proceeds from a potential IPO would be used to reduce indebtedness and to free up liquidity for the ongoing modernisation projects, and that the results for the current year will confirm the positive expectation for 2006 and 2007.

What Could Change the Rating - Up

Moody's would consider a rating upgrade upon the successful IPO, subject to a major part of the proceeds remaining within the company thus restoring the capital structure to largely pre share buy back levels.

What Could Change the Rating - Down

Moody's would consider a rating downgrade in the event that the company substantially increased its indebtedness such that, coupled with lower cash flows generated by the business, its cash flow-to-debt metrics deteriorated significantly.

Rating Factors

TMK

Steel Industry	Aa	A	Baa	Ba	B	Caa
Factor 1: Business Diversity & Size						
a) Operational Diversity			6			
b) Size (US$)				$2.80		
Factor 2: Cost Efficiency & Profitability						
a) EBIT Margin			8%			
b) Return on Assets			9%			
c) Other Liabilities / Equity		0%				
d) Raw Materials				3		
Factor 3: Financial Policies						
a) Debt / Capital		32%				
b) Debt / EBITDA			2.9x			
Factor 4: Financial Strength						
a) EBIT / Interest				2.5x		
b) (Cash from Operations -Dividends) / Debt				11%		
c) Free Cash Flow / Debt						-3%

Rating:						
a) Indicated Rating from Methodology				Ba1		
b) Actual Rating Assigned					B1	